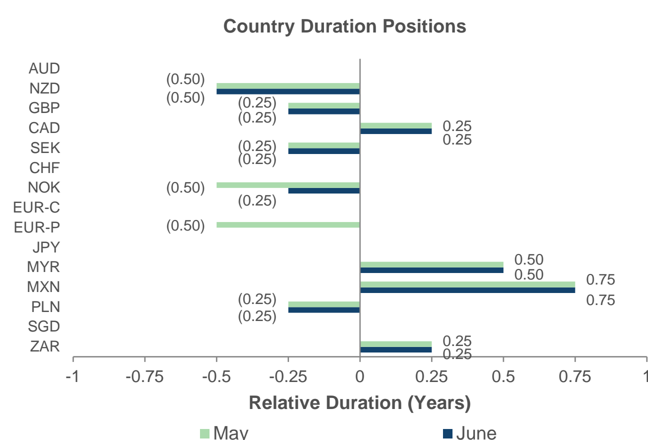
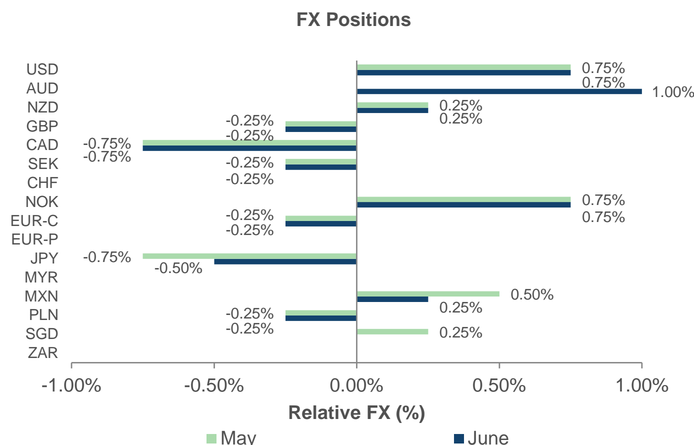
GLOBAL FIXED INCOME & CREDIT OUTLOOK





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Global Outlook

Global growth is becoming increasingly less synchronized, with the Eurozone, Japan and UK showing an ongoing moderation in growth, whilst the US remains robust. Unfavorable weather conditions in Europe earlier in the year had led to output disruptions within the manufacturing sector; though the negative impact should only prove temporary we are also seeing a broad softening of confidence indicators which could continue to weigh on activity. Nevertheless, generally still benign global financial conditions, including highly accommodative monetary policy in the Eurozone and Japan should see growth recover later this year. One of the most instrumental factors that has underpin the global growth acceleration to-date has been a recovery in global capital spending, which has been supported by cheap financing, leading to rising profits and improved business sentiment across both developed and emerging markets. The acceleration in aggregate demand also had positive implications for commodity prices. This paved the way for a significant pickup in economic activity amongst commodity exporters in both emerging markets and, to a lesser degree, developed markets. However, as financial conditions continue to tighten investment growth could be at risk of slowing somewhat from its earlier, elevated, pace.

Firmer commodity prices this year have seen a rise in global headline inflation (albeit from a low base). Higher geopolitical risks related to the war in Syria, Iran nuclear deal and Venezuelan crisis, have all lent support to crude oil, which has pushed headline inflation higher in recent months. Global core inflation, however, remains subdued, but the broad based improvement in labor market conditions across the globe is starting to put upward pressure on global wage dynamics. The still robust outlook for both real economic activity coupled with higher inflation should see a number of major central banks continue to look to scale back from their highly accommodative policy stance over the remainder of the year, putting sustained pressure on global bonds.

One risk to the global growth outlook has escalated in recent months in the form of increased protectionism. The removal of exemptions from tariffs on imported steel and aluminum by the Trump administration for Mexico, Canada and the EU, has already increased trade tensions, now the threat of Auto sector related tariffs risk further escalation. On another front, the potential imposition of a further $200bn of tariffs against China, in addition to a previously announced $50bn, appears to be directly aimed at China's alleged intellectual property rights violations. This previously proposed set of tariffs had already led China to threaten retaliation, with many investors now feeling anxious about the escalation in the trade war rhetoric between the world's largest economies.

On the domestic front, as the US economic activity looks to have improved substantially, the Fed look to be on course for a further two interest rate rises this year, following a hike in June. The outlook for inflation also continues to rise, with the domestic labour market showing no signs of cooling. We continue to believe that the broad based strength of the economy, as evidenced by tightening labour market conditions, improved household spending and larger fixed capital investment; together with a higher inflation trajectory, should see the Fed deliver a total of four hikes this year. Despite the bond market sell off so far this year, we continue to believe that the ongoing normalization of interest rates by the Fed, in conjunction with its balance sheet reduction should result in continual pressure on US treasuries over the course of

the year, though we are cognizant that our indicators do suggest that value has been restored, and that the scale of further moves higher in yields could be rather limited at this stage.

With a moderation in economic activity, albeit partly caused by weather related anomalies this year, growth momentum across the Eurozone has softened of late. In spite of this, the ongoing tightening of labour market conditions, has seen the European Central Bank (ECB) reduce its Quantitative Easing (QE) program, halting net purchases by the end of 2018. ECB president Mario Draghi has however tempered expectations for rate hikes, unlikely until late next year. Headline inflation is starting to show signs of life, primarily driven by higher commodity prices, estimated at 2% y/y as of June. More critical for policy however, core inflation remains stable, at 1%. Political risks have also escalated in recent months with the formation of a populist government in Italy and divisions within the German ruling coalition, which may also give the ECB cause for delay.

In Japan, labour market conditions remain tight, on the back of a demography related declining supply of workers. The ratio of open jobs to applicants stands at 1.6, a level that surpasses the bubble peak recorded in the mid-90s, yet wage pressures remain nowhere in sight. The BoJ Governor Kuroda has suggested that inflation remains on the right path to satisfy its official 2% target, yet the timing by which inflation hits this target, initially set at 2019-20, has now been removed, and now looks unlikely to breach 1.5% next year. As such, withdrawing monetary accommodation at this stage would certainly be premature. The BoJ, has however continued to reduce the total amount of bonds purchases. In our view, the move by the BoJ is an adjustment to reality, as opposed to some meaningful shift in its monetary policy.

In Emerging Markets, growth is still forecast to be slightly higher than in 2017, at circa 5%, though downside risks have increased of late. Chinese growth has been slowing this year, as authorities focus on the quality rather than the quantity of growth, with particular focus on reducing financial instability and pollution. However growth has softened more than expected of late and trade conflicts now pose the threat of a more meaningful slowdown in the second half of the year. Chinese authorities will now look to offset this with a combination of front loaded fiscal and monetary stimulus measures. EM ex-China should continue to improve, driven mainly by improving domestic demand, yet political uncertainty in a number of large economies, such as Brazil, may endanger the nascent recovery for the region. EM inflation should also continue to move higher in 2018, but the increase will not be broad-based. The end of disinflation will see further monetary policy divergence within EM. With a number of countries continuing to hike their policy rates in order to restore positive real yields, on the back of rising DM rates, as they strive to maintain their higher real yield relative to DM. Currencies of commodity exporters, on the other hand, which generally already offer high real yields, should continue to benefit from stronger commodity prices.

Developed Markets Positioning

The team has made the decision to marginally reduce its underweight duration position to move towards a more neutral stance in our positioning. The team has maintained its overall outlook on its US Dollar (USD) positioning in light of higher relative rate differentials as well as a more hawkish Fed in the face of weaker expectations for economic growth in Europe, continued Brexit risk in the UK and negative year over year growth Japan. The team continues to have concern over the escalating trade conflict between the US and the rest of the world. We view that it is likely Trump will keep his stance on tariffs through to the US mid-term elections. This can be seen as mainly a political play by Trump who is seeking to retain a republican majority in both houses of Congress in November. Given the team's strong USD view, we have maintained our underweight JPY view, but has marginally reduced this to take profit on recent weakness.

The team has reduced its underweight position on Norway duration. We have remained underweight overall based on the recent backup in interest rate levels, and the decision to take profit and because of expectations that hawkish views in Norwegian rates are more fully priced in. The team has maintained its overweight positioning on the Norwegian Krona, one of our highest conviction views, as Brent Crude futures hit a three year high.

The team has maintained its marginal underweight duration view on Sweden and FX underweight position on the Swedish Krona in line with the previous month as the Riksbank is likely to remain constrained by ECB policy irrespective of domestic inflation and growth.

In Europe, The team had closed out its underweight on Italy, where we decided to take profit, as the Italian political risks that were prominent during our last investment process meeting are now more fully priced into Italian sovereign spreads. We maintained our underweight on the Euro, given expectations for a more dovish ECB and a market pushback for the first ECB rate hike in late 2019.

The team kept its views of underweight gilt duration on views that lower Pound Sterling (GBP) will add to inflationary pressures in the UK while maintaining its slight underweight on the GBP as lack of political clarity on Brexit will likely serve as a catalyst for the BOE to remain on hold until the path is more apparent.

The team remained negative on its view on the Canadian Dollar as the team views market expectations as far too hawkish for the Bank of Canada. Market expectations for hikes will likely come down in the future as the BOC is likely to maintain a dovish policy stance in the face of increasing risk from the US led policy on tariffs, a renegotiation of NAFTA and minimal benefit from higher oil prices given the high cost of oil sands extraction.

Emerging Markets Positioning

In Emerging Markets we maintain a generally constructive view over the medium term, due to widening growth differentials relative to developed markets, though we continue to pare back our exposure given concerns over a tightening of US monetary policy and escalating trade tensions and the potential of global tariffs. We also remain selectively bullish on a number of EM rates markets as despite greater risks from the external environment inflation dynamics remain highly divergent with disinflation facilitating a more dovish stance in a select few countries.

We remain neutral on the Malaysian Ringgit as its recent outperformance looks stretched, with valuations no longer excessively cheap, as well as an increase in political uncertainty. Following earlier strength, the manufacturing side of the economy has slowed somewhat of late as global technology demand enters a soft-patch; nevertheless, this is likely to be offset by a strong rebound in energy prices. Bank Negara Malaysia hiked rates in January, as expected, however, given the lack of inflation pressures in the economy, we are likely to see an extended pause in monetary policy. Following the surprise election victory for the opposition Pakatan Harapan coalition the Goods and Services tax is set to be repealed which will likely cause a mild deterioration in the government's fiscal position, offset by lower inflation for consumers. Hence, we remain bullish on Malaysian rates.

We have reduced our overweight in the Mexican Peso due to greater uncertainty regarding trade and politics. Overall, however, we remain constructive due to its relative undervaluation and high carry, coupled with an increasingly hawkish rhetoric from Banxico. We believe that the proposed changes to NAFTA have weighed disproportionately high on the currency, with a termination of the deal still highly unlikely. Concerns regarding the election of Andrés Manuel López Obrador (AMLO) has also rattled investors of late, however, we expect that AMLO will likely moderate his stance towards both NAFTA and energy reforms. Meanwhile, inflation should continue to move lower, giving us more confidence in maintaining our long duration trade, with real yields now over 4% vs. core CPI.

We retain our bearish take on the Polish Zloty due to a recent slowing of growth momentum , as well as political risks associated with infringement proceedings from the European Union in relation to alleged breaches of "Rule of Law" principles related to recent judicial reforms. Longer term uncertainties also persist as the latest EU draft budget proposal for 2021-2027 indicates a material shift of funds away from Central and Eastern European (CEE) countries, such as Poland, towards southern Europe. We also remain underweight duration in Poland as despite the recent softening of inflation data, underlying inflationary pressures remain due to robust domestic demand and tightening labour markets, with valuations also stretched.

We removed our overweight on the Singapore Dollar this month as slowing external demand has weighed on the electronic sector this year, this sector would also be impacted further should the Sino-American trade conflict escalate. The Monetary Authority of Singapore moved to a positive appreciation bias in April which may still see the Singapore Dollar outperform some of its regional peers, despite these concerns. We remain neutral on duration despite a benign inflation outlook due to rich valuations and a high correlation with US Treasuries.

Finally, we remain neutral on the South African Rand as despite the positive sentiment toward the change in leadership in South Africa, investors are likely to encounter episodes of disappointment as Ramaphosa's reform agenda faces obstacles. Meanwhile, with core inflation remaining low, close to the mid-point of the SARB's inflation target, and growth disappointing of late, the SARB are unlikely to hike rates.

Global Credit Positioning

We maintain a defensive view on credit markets, and therefore are cautious in our current positioning. There is currently a mixed picture in global credit markets and is hard to see any trends appearing. Whilst most markets delivered a positive absolute return (except for LATAM and Asia HY), most markets also delivered a negative excess return (except for US HY and Asia IG). And this is a reflection of the current risk-off environment we are in at the moment, given the recent rhetoric regarding trade wars and the Italian crisis.

From a macro perspective In terms of political risk in Europe, we have seen the political tension in Italy calm down. The new government in place showed a commitment to the EU and the Eurozone which brought back confidence in the market. In Germany however, we did observe a mini political crisis emerging, where the interior minister Horse Seehofer voiced skepticism on Merkel's migrant policy which did threaten to break up her coalition. However, it was more recently resolved and Merkel reached a deal on immigration with the CSU and Seehofer to maintain the coalition. Therefore we maintain that Credit in Europe is still in a favourable environment.

We currently hold a view that there are attractive opportunities in Chinese asset management companies. We believe that this is a promising sector due to its leading and entrenched position in China's distressed assets markets and experience with distressed borrowers and projects. We continue to believe the asset management companies will play an important policy role in the current environment.

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